Yale SCHOOL OF MANAGEMENT
Program on Financial Stability

EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Resource Library

2013

The Public-Private Investment Program: An Assessment

Douglas J. Elliot

https://elischolar.library.yale.edu/ypfs-documents/8281

This resource is brought to you for free and open access by the Yale Program on Financial Stability and EliScholar, a digital platform for scholarly publishing provided by Yale University Library. For more information, please contact ypfs@yale.edu.

Initiative on
Business and Public Policy
at BROOKINGS

MARCH 23, 2009

The Public-Private Investment Program: An Assessment

Douglas J. Elliott

The Initiative on Business and Public Policy provides analytical research and constructive recommendations on public policy issues affecting the business sector in the United States and around the world.

Initiative on
Business and Public Policy
at BROOKINGS

The Public-Private Investment Program: An Assessment

Douglas J. Elliott

March 23, 2009

The Initiative on Business and Public Policy provides analytical
research and constructive recommendations on public policy issues affecting
the business sector in the United States and around the world.

CONTENTS

Introduction	7
Summary of the proposal	9
What are toxic assets and why do we care?	10
How big is the problem?	11
What approaches are available to deal with toxic assets?	11
Why did the Administration choose the PPIP approach?	12

Copyright © 2009 The Brookings Institution

INTRODUCTION

The Administration announced today a more detailed plan for moving "toxic assets" off of the balance sheets of the banks. The Public-Private Investment Program (PPIP) will combine money from private investment funds with public funds to buy toxic assets from the banks. The government will provide the great bulk of the funding, but the private investors will bring critical expertise that is intended to ensure that the right prices are paid for these complex assets, in addition to providing some of the funding. The Administration considers this private participation so critical that it is enticing them in with cheap financing and a floor under their potential losses.

It is critical to deal with the toxic assets (or "legacy assets," as they have been rebranded). U.S. banks own roughly $1-2 trillion of these assets, depending how they are defined. This has raised substantial fears about the banks, since the assets are of very uncertain value. The banks could have hundreds of billions of dollars of less capital if the toxic assets are worth the low end of the range of potential values, sinking some of the banks. Moving the uncertainty, and the potential for additional losses, off of the balance sheets of the banks is indeed a high priority, although it would not fix the credit crisis on its own.[1]

Will the PPIP succeed? Unfortunately, we will not know until we see the program in actual operation. There are substantial reasons to be concerned that the program will fizzle or prove to be too expensive for the taxpayer, but there are also some grounds for hope. The key determinants of its success or failure are:

Will the banks sell at the prices the investors are willing to pay? The current market for toxic assets is virtually non-existent because the investors and the banks disagree sharply on price. The value of the toxic assets is so uncertain that there are reasonable grounds for arguing that the average asset is worth anywhere from 30-60 cents on each dollar of face value. That is, everyone agrees they have lost at least 40% of their value, but it could be as much as 70%. The PPIP provides substantial economic incentives for investors to bid higher and the regulators will presumably push banks to sell. However, the valuation gap may simply be too large to bridge on reasonable terms for the taxpayer.

The Administration's counter to this concern is that the lack of a market today results from liquidity problems and a lack of transparency, both of which would be fixed by the government's intervention. Hedge funds and other potential investors find it difficult and very expensive to borrow to fund purchases of distressed assets. They also cannot easily discern a true market price, given the very low volumes of actual transactions. Government financing will eliminate the liquidity problem and the hope is that once a few transactions occur, they will snowball. Transparent market prices for a few securities will help investors and the banks to estimate the fair market price of additional securities, which will then help establish the price range for yet more securities.

Will the program cost the taxpayers too much? The government is providing large economic incentives that should persuade investors to participate and to willingly pay substantially higher prices than they otherwise would. The value of cheap multi-year government financing is quite

1. Please see "Designing the Public-Private Partnership" and "The Administration's New Financial Stability Plan" for more background. http://www.brookings.edu/~/media/Files/rc/papers/2009/0220_toxic_assets_elliott/0220_toxic_assets_elliott.pdf and http://www.brookings.edu/~/media/Files/rc/papers/2009/0210_bank_rescue_elliott/0210_bank_rescue_elliott.pdf

significant, as is the government's promise to put a floor under losses at 10 or 20% of what the investor puts up. It is possible that these incentives will cause investors to overpay for the assets, with most of the eventual losses flowing to the taxpayer because of the downside protection offered the investors. For example, it could be rational for investors to offer 40 cents on the dollar, calculating that they would benefit sharply if the price went to 50 cents while the government would absorb most of the losses if the value fell to 30 cents on the dollar.

There is also a substantial opportunity cost to channeling cheap funding to the investors. Perhaps other uses of that funding would have aided the economy more. For example, there are some who argue that the government would be better off buying the assets directly, contending that the economic subsidies are worth more than the expertise the investors are bringing. It will be difficult to judge this until we have considerably more detail about the program and even then it may be unclear.

Will investors participate? The answer here is almost certainly "yes." The government seems to have designed a program with enough economic incentives to lure investors in, despite sharply increased concern recently that the government might retroactively change the terms of the deal. Hedge funds worry that Congress will mandate changes to their governance or impose an "excess profits" tax if the contracts prove particularly valuable. However, these concerns are likely to be overcome by the potential profits and the downside protections. Press reports indicate two of the giants of the fixed income business, Blackrock and Pimco, intend to participate and there will doubtless be many others.

Summary of the proposal

The approach has evolved considerably from the high-level plan announced on February 10th, reflecting changing financial and political circumstances. The revisions generally appear positive, although a number of key details will not be known until later. There will now be three programs with different but overlapping approaches. Most of the funding will come from the Federal Reserve (Fed) and the Federal Deposit Insurance Corporation (FDIC) rather than from Treasury. This funding choice is driven more by the need to hoard Treasury's remaining authorized funding from the Troubled Asset Relief Program (TARP) than by substantial policy considerations. The Fed has virtually unlimited ability to lend on a secured basis and the FDIC is in a better position than Treasury to gain Congressional approval for new funding. The FDIC's favorable position stems from the theoretical ability to recover any losses through future deposit premiums and from the political ramifications of past actions by Treasury and the FDIC. The PPIP is targeting purchases of $500 billion to $1 trillion of assets, using $75-100 billion of TARP funding from Treasury.

There are three components to the plan:

Expanding the Term Asset-backed Securities Lending Facility (TALF) to cover toxic assets. Under this program the Federal Reserve loans private investors most of the funds they need to purchase securities backed by loans of various kinds. This program is very new; the first trades have not even closed yet. The original intention was to cover only highly creditworthy, new securitizations of loans to consumers and small businesses. Now the TALF will also cover old securitizations whose market values have declined sharply due to expected losses. How this works will be heavily dependent on details about the assets to be included, collateralization levels and the interest rates to be charged by the Fed.

A new set of Public-Private partnerships to buy securitized toxic assets. The government will support a series of new Public-Private Investment Funds (PPIFs) that will purchase toxic assets in their classic securitized form. There will likely be five funds initially, but this could be expanded. The Treasury and private investors will co-invest in the equity of the funds on a 50/50 basis. Treasury has further agreed to lend an amount equal to at least half of the equity and potentially as much as 100% of the size of the equity investment. (The interest rate has not yet been specified. This will be very important to the economics.) Importantly, the fund will have the ability to participate in the TALF program when it is expanded to cover toxic assets, which would open up substantially more leverage opportunities, using the Fed's non-recourse loan structure. Toxic asset purchases are likely to be much more attractive once the TALF financing becomes available.

FDIC-sponsored sales of loans. The FDIC will give banks the chance to offer for sale packages of loans of a similar nature to those underlying the toxic asset securitizations. The FDIC will auction these packages of loans off and will provide up to 6:1 leverage to the winning bidders, with the financing provided as FDIC-guaranteed debt. Treasury would expect to co-invest on a 50/50 basis with the winning bidder.

This paper will address the following questions.

- What are toxic assets and why do we care?
- How big is the problem?
- What approaches are available to deal with toxic assets?
- Why did the Administration choose the approach that it did?

What are toxic assets and why do we care?

"Toxic assets" has become the shorthand term used to describe a large set of complex securities whose value is tied in complicated ways to the value of mortgages and sometimes other financial instruments. This includes certain types of mortgage-backed security (MBS), asset-backed security (ABS), and collateralized debt obligation (CDO). There are two essential aspects that make a security toxic: (a) the security is complicated enough that it becomes difficult to value and (b) despite that, it is clear the value is well under its original face value. The complicated nature of these securities would probably not have been important if the mortgage market had held up, because they were generally structured to be fairly safe under "normal" conditions. However, they have proven extremely vulnerable to a significant fall in house prices.

Toxic assets would not matter much to the public except that major banks own large quantities of them. The banks have taken large losses on these positions, a problem which is considerably exacerbated by their very uncertain valuations. Some of these assets can legitimately be valued anywhere between 30 and 60 cents on the dollar, depending on one's views of future mortgage foreclosure and recovery rates, combined with differences of opinion on what rate of return a reasonable investor should demand. Rates of return make a big difference — getting paid $1 in 5 years is worth 62 cents now, if one wants to earn 10% a year, but only 33 cents if one insists on earning 20% a year.

The size and uncertainty of the positions owned by the banks makes them a major cause of the uncertainty about the solvency of the large banks. This solvency concern in turn has lend banks to focus on increasing their capital ratios.[2] This can only be done by raising more capital, which is difficult and expensive at the moment, or by cutting back on making new loans or investments. The decreased willingness to make loans is a major factor in the credit crunch that is hitting businesses and consumers and fueling the severe recession.

Almost everyone, including the Administration and the Fed, believe that the credit crunch will not let up until the banks are seen, and see themselves, as safe again. Removing the uncertainty caused by the toxic assets would greatly assist in achieving this goal

2. See "Bank Capital and the Stress Tests." link to document at http://www.brookings.edu/papers/2009/0303_bank_capital_elliott.aspx

How big is the problem?

No one knows the exact size of the problem, but it appears to be in the range of $1-2 trillion. Everyone recognizes that this is an important question, but there is no one accepted definition of "toxic assets" or "legacy assets." Even if there were, the asset categories reported on bank balance sheets do not exactly match with the various definitions, so that a balance sheet category would often include both assets we would consider toxic and other safer assets.

The IMF has published a detailed analysis of the expected credit losses from U.S.-originated credit instruments, ranging from loans to various types of securitizations. Applying reasonable estimates to the proportions of these instruments that are held by U.S. banks and broker/dealers yields an estimate of a bit under $2 trillion in face value of mortgage-backed and asset-backed securitizations. However, most of the $700 billion or so of Prime Mortgage-backed Securities will be money good and probably ought not to be included in "toxic assets." In addition, it makes more sense to focus on the marked-down value of the assets, since this is what remains on the books of the banks. Taking these factors into account brings the value modestly below $1 trillion. However, there are a number of loans retained on the books of the banks that are similar to those underlying the toxic securitizations. These appear to be in the range of half a trillion to a trillion dollars, depending in part on how much they have been marked down or had loan loss reserves set aside against them.

It is important to add one caution. It now appears that the severity of the recession will mean that the majority of the credit losses will come from safer categories of loans which will have lower percentage losses, but are much larger in size. Therefore, while it is important to deal with toxic assets, doing so will still leave a substantial issue with credit losses in other areas.

What approaches are available to deal with toxic assets?

There are three broad approaches available:

Address toxic assets indirectly by adding capital to the banks. The toxic assets become much less important if a bank has enough capital that it is safe even if they fall to the worst realistic value. The capital infusions under the TARP have therefore helped with the toxic asset problem, although they have not been large enough to eliminate the concerns. One advantage of adding capital is that it is available to bolster the bank against other problems if the toxic assets turn out not to be as bad as they could be. There are also disadvantages, but a fuller discussion lies beyond the scope of this paper.[3]

Buy the toxic assets from the banks. The PPIP approach is one variant of this. Removing the toxic assets from the banks eliminates the uncertainty that is fueling concerns about bank solvency. This approach almost certainly needs to be combined with capital infusions, since investors are generally unwilling to buy the toxic assets for the values at which they are carried on the books of the banks. Selling for less creates a hit to capital which needs to be made up by raising capital in some manner.

Guarantee the value of the toxic assets on the books of the banks. Another way to remove the uncertainty is to have the government provide a guarantee to the banks on the value of the toxic assets they own. This guarantee would normally be set below the best estimate of the current value of

3. Please see ("Bad Banks, Nationalization, and Guarantees of Toxic Assets," for more details.) http://www.brookings.edu/papers/2009/0129_banks_elliott.aspx

the toxic assets. This approach transfers less risk to the government than having it buy the toxic assets and avoids requiring the banks to sell. This is the author's preferred approach, as explained in "Bad banks, Nationalization, and Guarantees of Toxic Assets."

Why did the Administration choose the PPIP approach?

Three factors appear to have motivated the Administration:

Market pricing. The best method anyone has found for valuing an asset is to see what price would be arrived at between willing buyers and willing sellers competing freely. In addition, even if the government could do an equally good job of determining value in today's opaque conditions, it would be quite risky politically for the government to do so. In particular, there could be a firestorm of criticism if it appeared in retrospect that the government paid too much. Also, banks might find it easier to turn down a government-proposed price than to ignore true market indications of value.

Other people's money. Private sector funding is a useful complement to the government's own resources. Trying to buy a substantial portion of the toxic assets currently owned by the banks would exhaust the remaining TARP funding. Since Congress is highly resistant to approving more TARP funding, it makes sense to bring in as much outside money as possible. The Fed could be used, and is being used in the Administration's plan, but its nearly unlimited capacity under section 13-3 of the Federal Reserve Act is largely confined to secured lending. In addition, the Fed has a strong cultural bias against taking significant risk. For its part, the FDIC may find it easier than Treasury to obtain new funding from Congress and the banks, but its capacity is also constrained.

A virtuous circle. If the Administration is right, the first few transactions will spur a number of additional transactions which will inspire a much wider level of trading. Once the markets are restored, larger pools of private money would move in to finish the task. Government purchases or guarantees of toxic assets are unlikely to start such a snowball rolling downhill.

ABOUT THE AUTHOR

DOUGLAS J. ELLIOTT is a Fellow in Economic Studies at the Brookings Institution.

Initiative on
Business and Public Policy
at BROOKINGS

The Brookings Institution
1775 Massachusetts Ave., NW, Washington, DC 20036
(202) 797-6000

The Initiative on Business and Public Policy provides analytical research and constructive recommendations on public policy issues affecting the business sector in the United States and around the world.